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TAXATION

Limitations and Uncertainties of the 529 Plan

Saving for college is not as simple as it seems

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A 529 Plan (also referred to as a Qualified Tuition Program) is an investment account established pursuant to Section 529 of the Internal Revenue Code (IRC) as well as state law. It is a popular way for a family to save for college or other postsecondary education, while also serving as an estate planning technique. Although there are many positive aspects of a 529 Plan, there are also limitations and uncertainties that should be considered before investing in, distributing or rolling over a 529 Plan.

Owner and Beneficiary

Any person (not just a family member) can create or contribute to a 529 Plan for a named beneficiary, although the account is generally opened and funded by a parent or grandparent. The owner and contributor need not be the same person. Moreover, the IRC defines a "person" as including a trust, estate, partnership or corporation. To avoid certain abuses, the IRS has proposed regulations limiting an owner to an individual. Notwithstanding the broad definition of owner, a beneficiary must be a natural person.

Residency requirements vary by state. The New Jersey plan requires that either the owner or beneficiary be a resident. New York has no residency requirement. However, New York provides an income tax advantage (discussed below) to New York taxpayers who contribute to a New York plan, whereas New Jersey has no such advantage.

Both New York and New Jersey allow an owner, if an individual, to designate another person as a successor in the event of death. It also appears an owner can transfer the account to another owner at any time; however, because there is little guidance from the Internal Revenue Service as to the federal tax consequences of such transfers, it is not clear if it is a gift to the new owner. Some states, such as New York, allow for transfer of ownership but deem the transfer a nonqualified distribution.

An owner may transfer all or a portion of an account to another beneficiary without tax consequences, provided the subsequent designated beneficiary is a member of the family of the prior beneficiary. A member of the family includes ancestors and descendants of the beneficiary, step-children, siblings and step-siblings, step-parents, nieces and nephews, aunts and uncles, in-laws, spouses of any of the above and first cousins. A change of beneficiary to any person not related to the prior beneficiary is treated as a taxable distribution.

The ability to roll over the account is limited to once per 12-month period if to the same beneficiary; although there is no limit as to the number of times you may change the beneficiary on the account to a new beneficiary who is a family member.

Contributions and Investments

Contributions must be in cash (not stocks or property). As a result, gifts to the plan and use of the estate and gift tax exclusions (discussed below) cannot be leveraged. Although the federal law has no fixed dollar limit on the amount that can be contributed to a 529 Plan, it requires states to establish safeguards to prevent contributions in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. State laws generally base the limit on the actuarial estimated cost of five years of undergraduate education. New Jersey limits contributions to $305,000.

Neither the owner nor beneficiary may direct the investments, and each plan has limited investment options. In addition, owners may only change the investment strategy selected for the account once per year or when there is a change in the designated beneficiary. Finally, there are fees associated with maintaining the account, and neither the owner nor the beneficiary may utilize the account as security for a loan.

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Income Taxes

Contributions to a 529 Plan are not deductible on federal or New Jersey income tax returns. New York taxpayers are entitled to a state income tax deduction of up to $5,000 ($10,000 for married couples filing jointly) on contributions to a New York state 529 Plan. However, if the account is then rolled over into a non-New York plan or a non-qualified distribution is taken, the New York state taxpayer would be taxed on the earnings and be required to recapture any New York deductions.

Regardless of the deductibility of the initial contributions, the earnings are exempt from income tax provided they are used for qualified higher education expenses. Qualified higher education expenses include tuition, fees, books, supplies, equipment, and room and board at eligible institutions. Distributions for other than qualified higher education expenses (unless upon death or disability of the beneficiary, or as a result of a scholarship award) will result in the earnings being taxed to the recipient plus a 10 percent penalty.

Estate and Gift Taxes

A contribution to the 529 Plan account is considered a completed gift of a present interest for purposes of estate and gift taxes; therefore, if the contribution is in excess of the annual exclusion amount (currently $14,000 per donee per year) a gift tax return must be filed, and part of the donor's exemption amount ($5,340,000 in 2014) utilized. A donor is permitted to make an accelerated gift to a 529 Plan equal to five times the annual exclusion amount ($70,000) in one year and not deplete the exemption amount. If the donor dies within five years from the date of such gift, a pro-rata portion will be brought back into the donor's estate for estate tax purposes. Otherwise, because the contribution is a completed gift, it will not be included in the owner's estate upon death.

Even though the contribution to a 529 Plan is deemed a completed gift to the beneficiary, the donor, if named as the owner, may still control the account by withdrawing funds or changing the beneficiary on the account. Because the owner has retained such rights, it is not clear if upon the death of the beneficiary prior to a distribution, the account will be included in the gross estate of the beneficiary. The proposed regulations require inclusion in the estate of a beneficiary the value of any interest in such a plan; however, it is unlikely a tax will be applied if the account is never distributed to the estate of the beneficiary.

Financial Aid

Notwithstanding the existence of a 529 Plan for a student's benefit, additional financial assistance may be required by the student due to the high costs of education. It may be possible to optimize the financial aid available by careful planning as to designation of the account owner and the designated beneficiary. In calculating the expected family contribution in connection with the Free Application for Financial Student Aid (FAFSA), if the student is named the owner, the federal financial aid criterion assesses the account at 20 percent.

On the other hand, if the parent is the owner of a 529 Plan for the benefit of the applicant, then the account is assessed at no more than 5.64 percent of its value. If the parent is the owner of a 529 Plan but the student is not the beneficiary of such a 529 Plan, the assets are not considered. If the grandparent or anyone other than the student or parent is the owner of a 529 Plan for the benefit of the student, the assets will not be considered as available to any extent. However, if the grandparent is the owner and makes a distribution from the 529 Plan to the student, then the distribution is reported as unearned income and assessed at a rate of 50 percent on the next year's FAFSA application. With this in mind, optimal planning for financial aid purposes would suggest that if the account would only pay one year of expenses, then the account owner should be the grandparent and the account used in full for expenses in the final year of studies. If the account is more substantial and to be utilized in more than one year, the parent, not the student or grandparent, should be named account holder either from onset or prior to distribution of the account as discussed further below.

The FAFSA is not the only application for financial aid. Individual schools may have their own forms and assessment standards and/or require completion of the College Board College Scholarship Service (CSS) Profile. In connection with the CSS, unlike the FAFSA, if the parent is the owner of a 529 Plan for the sibling of the student applying for aid, the asset will be included as a parental asset.

Medicaid/Creditors

A contribution to a 529 Plan is considered a transfer for purposes of Medicaid qualification. Moreover, a 529 Plan owned by the Medicaid applicant would be considered an available resource to the applicant (since withdrawals can be made at any time by the owner), thus potentially disqualifying the applicant for Medicaid. To avoid disqualification for Medicaid, a contributor to a 529 Plan should make the contribution more than five years before potentially filing a Medicaid application and should not be named as the owner.

Absent a state statute, a 529 Plan would be an available asset to the owner's creditors. New Jersey's statute does protect the account from creditors of the donor or designated beneficiary but not the owner. New York's statute protects the account from creditors of the owner but only where the beneficiary is a minor or in an amount not exceeding $10,000.

Investing in a 529 Plan has advantages and disadvantages when compared to other investment, savings and estate-planning or gifting alternatives. Should the plan be deemed appropriate, the state in which the plan is established and the owner named on the account, as well as the designated beneficiary, may have significant consequences. Even the timing of establishing or distributing funds from the account should be carefully considered. Absent further guidance by way of regulations, uncertainties as to tax treatment of some transactions exist. Such uncertainties, together with the limitations and alternatives to 529 Plans, need to be considered. ■